



## Q1 2010 Review and Commentary

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***“High fiscal deficits and higher outstanding debt lead to higher real interest rates and ultimately higher inflation, both trends which are bond market unfriendly.”***

- Bill Gross, manager of the world’s largest bond fund, PIMCO *Investment Outlook* April 2010

### The Middle Kingdom

*An Investor’s View of China*

[Charles B. Atwill, CFP®](#)

WINSTON CHURCHILL ONCE DESCRIBED the Soviet Union’s foreign policy as “a puzzle inside a riddle wrapped in an enigma.” That seems to be an apt description of America’s largest trading partner and home to an estimated 1.34 billion people, China. Central to unlocking the investment potential of the world’s most populous nation is understanding its cultural transformation and evolving relationship with the West.

China (colloquially referred to as the *Middle Kingdom* by its denizens) has been undergoing a rather radical transformation over the past several decades, developing from a largely agrarian economy and culture into an increasingly modern, industrialized society. In 2009, the U.S. imported **19%** of all of its goods from China (**\$296 billion**). Yet, for the same period, only **6.6%** of our exports went to China, valued at **\$69.6 billion**.<sup>1</sup> For now, this annual *trade deficit* of nearly \$227 billion is financed in large part by China’s purchase of U.S. government debt.

#### **An Uneasy Relationship**

As China officially holds approximately **21%** (**\$800 billion**) of the **\$3.7 trillion** in U.S. Treasury debt owned by foreign investors, one can imagine that China would seek to diversify its risks a bit.<sup>2</sup> Being so economically dependent

on another country (particularly when the other country has the kind of fiscal problems the U.S. is facing), would be a strong motivator for China to look for more secure regional trading relationships for its domestic economy. Indeed, that is occurring right now.

China is increasingly more interested in trading its surplus dollars for “tangible goods” like oil, precious metals, iron ore, base metals, and other raw materials. Securing these resources provides a two-fold benefit: first, as a burgeoning industrial superpower, it allows them to shore up their access to critical resources to facilitate economic growth, and second, it allows them to trade a growing pile of U.S. dollars, in which they are becoming less and less confident as a store of value.

An overwhelming risk to the Chinese economy is a significant downturn in import demand by its trading partners in the West. According to the *CIA World Factbook*, over 20% of China’s exports are accounted for by the U.S. and Germany alone. Add the rest of the European Union to that figure, and one can clearly see that quite a few of China’s economic eggs are in the West’s basket.

So, what’s the *good news* in all of this? For the investor, China’s long-term interest in developing its enormous domestic consumer market (remember, 1.34 *billion* people) provides a fertile opportunity to invest in what their growing population wants and needs. As their domestic consumption increases, China reduces its dependence on the

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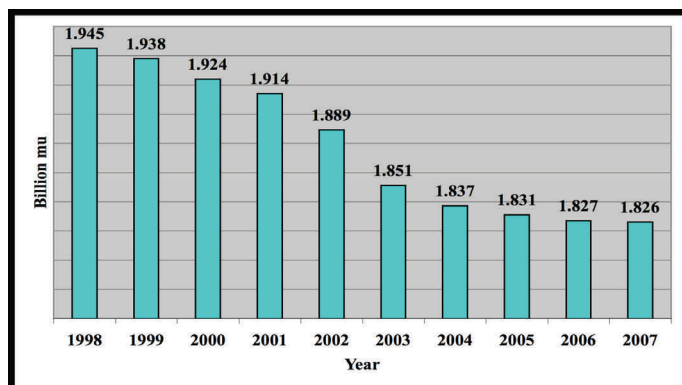
West’s desire (and financial ability) to import its goods.

**Feeding the Dragon**

A major demographic trend in China is its agrarian class migrating from farms into cities, leaving fewer farmers to feed a rapidly growing population and middle class. As this trend continues, farmers are forced to improve the efficiency of their operations to meet the basic demand for food.

China accounts for 22% of the world’s population, but has only 7% of the world’s arable land (and the trend has not been positive in this respect).<sup>3</sup> Rising prices for fertilizer worldwide — a 100% increase since 2000 — means an added burden for Chinese farmers already struggling to meet their country’s need for food.<sup>4</sup>

Decrease in China’s Arable Land 1998-2007



Source: *Renmin ribao* (People’s Daily), 27 October 2008. Originally based on the website of the Ministry of Land Resources, the People’s Republic of China.

For client portfolios, we are investing in several innovative food processing and fertilizer companies that are scaling up commercial production in China. The business segments of

these companies include Western-style livestock production, improved aquaculture practices, and organic fertilizer production and distribution for China’s sustainable “green” agriculture movement.

In addition to feeding the nation, Chinese officials are motivated to keep family farmers from failing and migrating into cities. Housing and job shortages in urban areas have reinforced the need to promote the long-term sustainability of China’s farming communities. President Hu Jintao has made the modernization of China’s agricultural infrastructure a centerpiece of his administration. In fact, nearly 10% of China’s 2008-2010 Stimulus Budget is directed towards that end and 45% is allocated to rail, roadway, and airport construction – largely benefiting rural communities.<sup>5</sup>

As China continues on its path to first world status as a modern industrial state, we find investments in its infrastructure development and food production to be promising. The risks to growth – which every economy faces – are certainly there. Its centrally planned economy has been running white-hot for several years, prompting Chinese banking officials to tighten money supply over concerns of inflation and an urban real estate bubble. China’s growth is dependent as well on access to (and prices of) critical energy and natural resources – in large part explaining their drive to expand their global footprint in these markets.

On balance, the longer term opportunities for strategic investment in the modernization of the Middle Kingdom seem more compelling than those of the increasingly debt-laden West.

<sup>1</sup> U.S. Census Bureau Foreign Trade Statistics

<sup>2</sup> U.S. Department of the Treasury

<sup>3</sup> Cheng Li, “Hu Jintao’s Land Reform: Ambition, Ambiguity, and Anxiety,” *China Leadership Monitor* No. 27 (2009)

<sup>4</sup> U.S. Department of Agriculture/World Index

<sup>5</sup> Cheng Li, *China Leadership Monitor* No. 27 (2009)

The AFCG *Absolute Return Models* are based on a “Core and Explore” strategy employing a tactical asset allocation.

- The **Core** element functions as the more stable, income-oriented foundation of the portfolio.
- The **Explore** element focuses on capital appreciation, providing scalable exposure to more growth-oriented assets.

**AFCG Absolute Return Models April 2010**

|              |                             | Target Allocations by Model |             |              |
|--------------|-----------------------------|-----------------------------|-------------|--------------|
| Asset Class  |                             | Growth                      | Balanced    | Conservative |
| Core         | Cash / Money Market         | 12%                         | 19%         | 40%          |
|              | Gold / Silver Bullion Fund  | 15%                         | 15%         | 15%          |
|              | World Bonds                 | 7%                          | 13%         | 20%          |
|              | Allocation Funds            | 8%                          | 13%         | 20%          |
|              | Rising Rates Fund           | 15%                         | 10%         | 5%           |
|              | Subtotal                    | 57%                         | 70%         | 100%         |
| Explore      | Global Resource Equities    |                             |             |              |
|              | Energy Equities             | 43%                         | 30%         | 0%           |
|              | Gold Mining Equities        |                             |             |              |
|              | Global Agriculture Equities |                             |             |              |
| Subtotal     | 43%                         | 30%                         | 0%          |              |
| <b>Total</b> | <b>100%</b>                 | <b>100%</b>                 | <b>100%</b> |              |

## Economic and Capital Markets Outlook

*Justin D. Harris, AAMS®*

IN OUR Q4 2009 REVIEW AND COMMENTARY WE discussed the material risks that financial markets are facing in 2010 as a result of excessive government spending. In January, we stated that the two primary risk factors investors will likely have to cope with for the foreseeable future due to deficit spending and ballooning U.S. debt are:

- rising interest rate risk; and
- inflation risk

Global events that have occurred so far in the first quarter of 2010 support our ongoing assessment that these risks are clear and present in the capital markets.

As a result of myopic fiscal and monetary policies being implemented by policymakers to 1) bail out preferred segments of the economy—namely the large commercial banks and their bondholders; 2) make good on increasing obligations of underfunded government guarantees and entitlement programs; and 3) add new spending and entitlement initiatives, the U.S. federal debt level is exploding upwards.

According to data provided by Bloomberg, the following has occurred so far this year with respect to the U.S. budget deficit for fiscal 2010 (which began October 1):

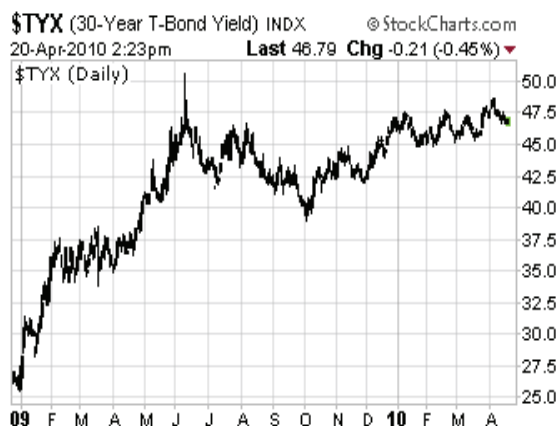
- the U.S. budget deficit hit a record \$221 billion for the month of February, which was an increase of nearly 14% from the February 2009;
- for the first five months alone in fiscal 2010, the deficit has already reached \$651.6 billion compared to \$589.8 billion for the same period in fiscal 2009; and
- the U.S. deficit for the fiscal year 2010 ending in September is set to exceed the record \$1.4 trillion deficit reported for fiscal 2009.

Shown in the upper right is a chart of the exchange-traded fund iShares Barclays 20+ Year Treasury Bond Fund (symbol: TLT). The fund's negative investment performance since the end of 2008 is indicative of the risk of owning longer term U.S. bonds when interest rates rise as foreign investors like China purchase less of our debt.

Investors who purchased TLT (or other forms of longer term U.S. treasury debt securities) at the end of 2008 in a flight to "safety" have experienced over a 20% move down since then. The risk to the financial markets is that this move up in interest rates (causing bond prices to fall) is merely a preview of what is to come in the years ahead based on the current trajectory of record U.S. budget deficits.



Since December 2008, yields on long-term U.S. bonds have risen by nearly 90% from 2.5% to 4.7% as of April 20 [see chart below].



**Key Point:** In a volatile interest rate environment characterized by inflationary monetary and fiscal policies like we currently have, overvalued bonds can experience the type of volatility and capital losses usually associated with a declining stock market — even with bonds that have traditionally been considered to be “safe” investments.

Interest rates are nearing a major inflection point as the market yield on long-term U.S. Treasury bonds approaches 5.0%. We are watching the bond market very intently for signals that a sustained move above the important 5.0% level is occurring, since this could very well send economic policymakers further into reactionary panic mode this year.

### A Warning From the Bond King

The quote at the top of Page 1 was excerpted from the monthly market commentary written by PIMCO's Bill Gross, the renowned bond expert and manager of the world's largest bond fund with \$220 billion in assets.

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## Economic and Capital Markets Outlook (continued)

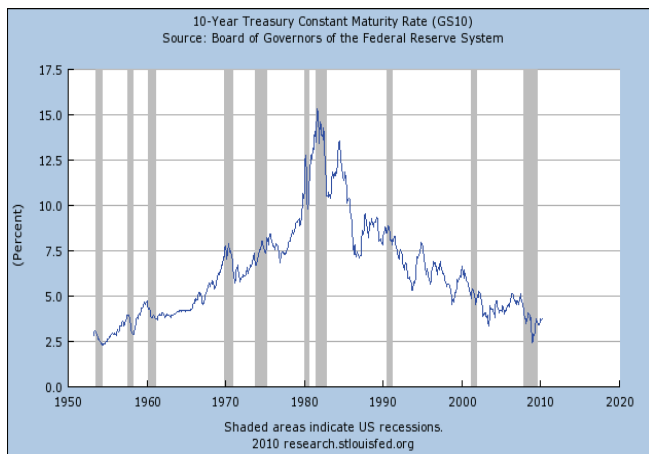
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In his April 2010 *Investment Outlook* entitled “Rocking-Horse Winner”, Mr. Gross remarks on the increasing risks to the sovereign bond and currency markets of developed Western nations from the headwinds of “deleveraging, re-regulation, and the forces of deglobalization”. Essentially, he expresses similar concerns that we share about the dual threat ahead for the markets: a rising interest rate cycle and elevated inflation attributable to excessive deficit spending by governments.

When the widely respected bond king, Bill Gross, issues what amounts to fair warning to bond investors about a perceived shift in the global risk level affecting bonds as an asset class going forward, we certainly sit up and take notice. A link to PIMCO’s commentary is available [here](#).

We concur with the judgment of Bill Gross regarding the investment risks stemming from a massive expansion of the public sector in response to the implosion of the real estate/debt/derivatives bubble. As inflationary policies are implemented by the government to counter a deflationary debt contraction (the “bust” phase of the debt bubble), the risks detailed by Mr. Gross intensify.

Below, we include a familiar chart of the historic yield on the 10-Year U.S. Treasury note going back to 1953. During the last serious inflationary recession in the 1970’s, rates went from 5% in the late 1960’s to over 15% by 1982.



Since 1982, bonds have been in a secular (long-term) bull market as rates fell and bond prices rose along with the stock market. Our research indicates that the twenty-seven year bull market in U.S. bonds is likely in the process of ending as we enter a secular rising interest rate cycle ahead due to the current economic policy regime.

Clearly, the still-fragile banking system and struggling real estate markets would be negatively affected by such a major trend change. Our analysis is that global investors are beginning to question the investment merits of buying and

holding longer term U.S. Treasury notes and bonds denominated in U.S. dollars, given the evolving global risk perspective expertly described by Mr. Gross.

### **Inflation, China, and Real Estate Update**

As we routinely mention in our periodic commentaries and in discussions with clients, we view inflation as “a monetary phenomenon” caused by deficit spending and associated money-printing by the central bank. As consumers and investors, we then feel the effects of inflation in the real economy by experiencing chronic rising prices, in dollar terms, for basic necessities like food and energy.

As part of this trend, we have seen a shift in the global financial markets as emerging nations (e.g., China) have been steadily exchanging their paper dollars for more limited supplies of tangible natural resources around the world. In effect, rather than recycling as many dollars back into U.S. debt as they have in the past, our foreign creditors are, instead, now spending these dollars to lock-up access to oil, gold, copper, and other natural resources in Canada, Africa, the Middle East, Australia, and Latin America.

A sampling of financial news headlines from the past few months further confirms a continuation of this inflationary trend into 2010 – a trend that also remains a growing national security issue for our import-dependent economy:

#### **Steel Prices Set to Soar After Iron Ore Deal**

March 31 (Financial Times) -- Global steel prices are set to leap by up to a third, pushing up the cost of everyday goods from cars to domestic appliances, after miners and steelmakers on Tuesday agreed to a ground-breaking change in the iron ore pricing system. The deal by Vale of Brazil and Anglo-Australian BHP Billiton with Japanese and Chinese steel mills marks the end of the 40-year-old benchmark system of annual contracts and lengthy price negotiations. The industry instead agreed to move to quarterly contracts linked to the nascent iron ore spot market. “The benchmark system has ended. There is no comeback,” said a senior mining executive directly involved in the talks.

#### **Saudi Aramco CEO Says China Overtakes U.S. as Largest Customer**

January 28 (Bloomberg) -- Saudi Arabian Oil Co., the world’s biggest crude producer, is exporting about 1 million barrels a day to China, more than to the U.S., Chief Executive Officer Khalid al-Falih said. “We are already exporting more to China than to the U.S.,” he said today in an interview in Davos, Switzerland. “We are prudent and careful about where to invest but our eyes are focused on China and we will continue to look for all opportunities”

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## Economic and Capital Markets Outlook (continued)

(Continued from page 4)

### Sinopec Group Pays \$4.65 Billion for Syncrude Stake

April 13 (Bloomberg) -- China Petrochemical Corp. agreed to pay ConocoPhillips \$4.65 billion for its stake in Syncrude Canada Ltd., a higher price than analysts expected, as Asia's biggest refiner seeks overseas petroleum reserves. China Petrochemical, the Beijing-based company known as Sinopec Group, will buy about 9 percent of oil-sands producer Syncrude through its unit Sinopec International Petroleum Exploration & Production Co., according to a statement issued by Houston-based ConocoPhillips yesterday...

China, the world's largest energy consumer behind the U.S., relied on imports to meet more than half of its oil needs last year. The country's dependency on imported crude will continue to rise, PetroChina Chairman Jiang Jiemin said last month. Annual domestic oil production is unlikely to exceed 200 million tons by 2020 while demand may increase to about 600 million tons by then, according to Jiang.

In addition to the inflationary global resources grab by China, the U.S. economy must continue to deal with a deflating real estate sector — a factor that portends more government bailouts fueling even higher deficits and more money-printing by the Fed.

Recently, the Congressional Oversight Panel (COP) formed by Congress in October 2008 to “review the current state of financial markets and the regulatory system”, issued an *Oversight Report* on February 10, entitled “Commercial Real Estate Losses and the Risk to Financial Stability”. The report is 190 pages of mind-numbing reading but does provide a succinct executive summary, which states the following important points [bold emphasis is ours]:

- “Over the next few years, a wave of commercial real estate loan failures could threaten America’s already-weakened financial system. The Congressional Oversight Panel is deeply concerned that commercial loan losses could jeopardize the stability of many banks, particularly the nation’s mid-size and smaller banks, and that as the damage spreads beyond individual banks that it will contribute to prolonged weakness throughout the economy.”
- **“Between 2010 and 2014, about \$1.4 trillion in commercial real estate loans will reach the end of their terms. Nearly half are at present “underwater” — that is, the borrower owes more than the underlying property is currently worth.** Commercial property values have fallen more than 40 percent since the beginning of 2007.”
- **“The largest commercial real estate loans losses are projected for 2011 and beyond;**

losses at banks could range as high as \$200-300 billion. The stress tests conducted last year for 19 major financial institutions examined their capital reserves only through the end of 2010. Even more significantly, small and mid-sized banks were never subjected to any exercise comparable to the stress tests, despite the fact that small and mid-sized banks are proportionately even more exposed than their larger counterparts to commercial real estate loan losses.”

- “The Panel believes that Treasury and bank supervisors must address forthrightly and transparently the threats facing the commercial real estate markets. The coming trouble in commercial real estate could pose painful problems for the communities, small businesses, and American families already struggling to make ends meet in today’s exceptionally difficult economy.”

As the report details, the systemic mortgage problems in real estate are expected to continue to worsen over the next four years causing very elevated levels of financial risks relative to what Americans have typically experienced over the past two decades. For investors, this makes the concepts of risk management and wealth preservation paramount until we get through this corrective cycle.

The full COP report is available on our web site [here](#).

### AFCG’s Investment Strategy

Given the fact that serious financial problems in the banking system continue to be swept under the rug by on-the-fly accounting rule changes (the policy of “pretend and extend” reviewed in our [Q4 2009 Review and Commentary](#) on Page 3) and transferred to the public sector (i.e., the taxpayer), we continue to rely on our asset allocation and sector investments to mitigate risks and contribute multiple sources of total return for client portfolios.

Our primary investment goal is to achieve *broad* diversification by blending exposure across additional asset classes beyond U.S. stocks and bonds to protect against market volatility, inflation/currency devaluation, sovereign debt defaults, and rising interest rate risk. We expect precious metals (gold/silver) to continue to serve as the ultimate safe haven asset class for global investors as we head into the economic period ahead.

On the following page, we have listed the six asset classes we currently use in our absolute return models with a brief comment about how each asset class contributes to the overall risk management strategy.

[**Note:** For client portfolios under \$200,000 we generally use more mutual fund-oriented investments to implement the guiding asset allocation objective.]

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### Asset Class #1—Cash and Currency Funds

**Strategy:** Holding cash and short-term cash equivalents in the form of U.S. dollar money market funds and non-dollar currency funds provides a balance of liquidity and protection from inflation and rising interest rates.

### Asset Class #2—Precious Metals Bullion

**Strategy:** Having exposure to gold/silver bullion as *sound monetary assets* during the current economic cycle helps protect against fiat currency devaluation, sovereign debt default risk, and waning global confidence in paper assets.

We invest in gold/silver bullion indirectly by owning shares of a publicly traded closed-end fund whose assets consist of allocated, unencumbered, and fully segregated gold/silver bullion stored underground in a major Canadian bank.

### Asset Class #3—World Bonds

**Strategy:** Owning shorter term (low duration) “go-anywhere” bond funds that invest in both U.S. and non-U.S. bond markets helps generate income in a diversified fashion and can minimize bond market risk factors.

Adding portfolio exposure to Emerging Market bonds also offers inflation protection as these bonds typically pay higher yields and rise in value as the U.S. dollar falls vs. the stronger currencies of better managed economies.

### Asset Class #4 — Allocation Funds

**Strategy:** Allocation funds are mutual funds in which the underlying investments are usually other mutual funds — these are also called “fund of funds”. We use four actively managed allocation funds in our models to benefit from each fund manager’s respective expertise in providing total return and volatility management during difficult markets.

### Asset Class #5 — Rising Rates Fund

**Strategy:** As prices on long-term U.S. bonds fall, a rising rates fund is designed to go up in value. This can provide profit potential independent of the stock market and hedge an overall portfolio from the risk of a spike in interest rates.

### Asset Class #6 — Global Equities

**Strategy:** Buying shares of companies that own real assets and produce real products that economies need to function is our approach to investing in stocks during inflationary monetary cycles. Our portfolio exposure to stocks is specifically targeted to hard asset sectors including Energy, Natural Resources, Metals Mining, and Agriculture.

Our individual stock and equity fund selections emphasize growing small and mid-cap companies that are also attractive acquisition targets for larger companies and global suitors, including China. We have been accumulating more of these sector investments for client portfolios in 2010 and will add additional investments as opportunities arise.

#### Sources:

1. Bloomberg ([www.bloomberg.com](http://www.bloomberg.com))
2. Stockcharts ([www.stockcharts.com](http://www.stockcharts.com))
3. Financial Times ([www.ft.com](http://www.ft.com))

4. St. Louis Fed ([www.stlouisfed.org](http://www.stlouisfed.org))

5. PIMCO ([www.pimco.com](http://www.pimco.com))

6. Congressional Oversight Panel ([www.cop.senate.gov](http://www.cop.senate.gov))

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